



Memorandum

To: Council Subcommittee for the Pacific View Site Activation Plan
FROM: Best Best & Krieger LLP
DATE: October 2, 2014
RE: Pacific View Property - Private Use

The Pacific View property is currently under due diligence review by the City of Encinitas for potential purchase. The City is considering several possible uses for the property, though it has not settled on any particular use or the manner of operation. When considering the possibility of tax-exempt financing of the property, the expected use and operation of the property is crucial to the determination of whether all or a portion of the property may be financed with tax-exempt bonds.

For your and the Council's consideration we have prepared a few scenarios which set outside limits for tax-exempt financing. For federal tax purposes, the property must be used for public purposes and not for the benefit of any private user. Bonds are private activity bonds if they meet either (1) the private business use and private security or payment test of § 141(b) or (2) the private loan financing test of § 141(c).

Generally, the private business tests are met if (1) more than 10% of the proceeds of an issue is used in a trade or business carried on by a nongovernmental person (the "private business use test") and (2) the payment of principal or interest on more than 10% of the issue is directly or indirectly (a) secured by property used or to be used for a private business use or payments in respect of such property or (b) to be derived from payments in respect of property used for a private business use (the "private payments or security test").

These 10% limitations are reduced to 5% for private business uses that are unrelated or disproportionate to the governmental uses financed by the issue and for payments or security relating to such uses. The private loan financing test generally is met if more than the lesser of 5% or \$5 million of the issue is to be used to make or finance loans to nongovernmental persons.

Private use is measured by the overall area of the use and the duration of the use compared to the life of the outstanding bonds. We also look at all uses on a cumulative basis for determine private use and public use. We also wish to note that we think it will be very difficult to split the uses on the property for purposes of determining whether separate portions of the property may be financed with tax-exempt or taxable bonds, as the size of the property is small enough that essentially all of the property will be used for one use at a time.

We have discussed possible interim uses for the property while the City determines its ultimate permanent use. The interim uses are as important as the ultimate use when considering whether the property may be financed on a tax-exempt basis. Suggested interim uses include an open air market, downtown valet parking services, or educational services

geared toward the arts. Additionally, we are aware that the Encinitas Historical Society currently uses a portion of the property and the old school house located on the site. The use by the Historical Society constitutes a private use.

Utilizing an open air market as an example for determining whether there is public or private use is illustrative of public and private uses generally.

1. Public Uses – an open air market that was operated by the City would most likely be a public use. The City would need to be the organizer of the market, get vendors, permit them and generally operate and manage the open air market. Vendors would be able to obtain permits on a first come first serve basis. This constitutes public uses if the individual vendors compete for access on the same basis as the general public and is a use that does not endanger the tax exemption of the bonds.

2. Private Use - private use in the example of an open air market could be a private individual or company that leases the property from the City, or has the right to exclusive use of the property, and organizes vendors to sell at the open air market which it would operate as its business. This use is a private use and would not permit tax-exempt financing.

3. Permitted Private Use- in some circumstances, a private person could operate the open air market without jeopardizing the tax exempt status of the bonds. A private business operating the market for the City under a qualified management contract does not constitute impermissible private use. The City already has experience with its type of arrangement in the operation of the golf course. There are many limitations on the length of the term of the contracts and the amount and manner of compensation paid to the manager. Additionally, the manager could be a qualified non-profit 501c(3) corporation. There are limitations on the length of use and the manner of compensation as well. Additionally, there are certain actions which need to be taken by the City (such as another public hearing), and there will be limitations on the City's ability to pay costs of issuance from bond proceeds.

For purposes of this discussion, we have tried to be very general and give the City Council outside limits for consideration of how it might want to proceed. These same rules would apply if the property would ultimately be used for any other purpose, for example, as a performing arts center. Alternatively, the Council may determine that a portion of the property, for example, existing structures on the property, are amenable to a private use, but that the open space will be held for public recreational use. Ultimately, every use, that is not a traditional governmental use on the property, would need to be reviewed by bond counsel to ensure compliance with tax-exempt bond provisions in the Code and the documents, prior to the use being permitted.

Alternatively, the City could finance the purchase of the Pacific View property with the proceeds of taxable bonds. Taxable bonds do not have restrictions as to use, other than compliance with state law. The City could use the property to allow open air markets, educational uses (whether for profit or non-profit), and any other viable interim or final use. These uses would not need initial review by bond counsel. Additionally, the users could pay the City for the uses, either as lease payments or a split of fees received.

On a final note, we wish to point out that the IRS has undertaken a very active audit program of public agencies regarding use of proceeds and investments. Most of the audits are conducted randomly, however there are certain target audits that the IRS will conduct in given years. The IRS looks at all of the uses of the proceeds of the bonds and the facilities financed with the tax-exempt bonds. If they conclude that the limitations as to permissible private use have been violated, they will declare the bonds taxable from the date of issuance and seek to tax the owners of the bonds or require the issuer of the bonds to make a payment to the IRS to settle the audit. This audit program is one reason we, as bond counsel, try to be vigilant as to the uses of the properties that are financed on a tax-exempt basis.

Because of the potential uses for the property that the City has discussed with the public, in particular the interim uses, in addition to the current use by the Historical Society on a portion of the property, we believe that it is most prudent for the City to use taxable bonds to finance the purchase of the Pacific View property.

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